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John Dessauer's market review and update as of Wednesday September 16, 2015

Will they take the risk? Is this 1984 with a Chinese twist? We will soon find out.

This is the week. The U.S. Federal Reserve will decide whether or not to start raising U.S. short term interest rates. Many U.S. economists think the U.S. economy is strong enough to absorb an interest rate hike without slowing. Bill Gross, now a principal at Janus, says the Federal Reserve is too late and has missed the timing on an interest rate hike. In contrast *The Economist* magazine had this to say in its September 12th issue: "The Fed should wait until inflation is closer to target before raising rates."

Christine Lagarde, head of the IMF (International Monetary Fund) said it best: "The U.S. Federal Reserve should not rush its decision to raise interest rates and should move only when it is sure the decision is unlikely to be reversed later."

Under Paul Volker, the U.S. Federal Reserve began a monetary tightening cycle in 1983. By 1984 chairman Volker was convinced inflation was about to rise significantly. He ratcheted up U.S. interest rates to counter the perceived inflation pressure. He was wrong. Inflation did not rise, but the dollar did. The dollar soared in response to high and very attractive U.S. interest rates. It was a great time to be in London. A dinner out at a fine restaurant became very cheap for American visitors. But, the soaring dollar was bad news for U.S. exporters and the U.S. economy. The lack of

inflation and the economic damage from a soaring dollar forced Volker to reverse course and bring U.S. interest rates back down. I don't know if Ms. Lagarde was thinking of Paul Volker and 1984 when she advised Fed chair Yellen and company to be sure they won't be forced to reverse course before starting to raise interest rates. However, she is correct about the risk and it is, like 1984, in large part a currency market risk. The dollar has been strong - up about 20% on a trade weighted basis over the last year. The strong dollar has taken a bite out of reported U.S. corporate profits and is hurting U.S. exporters and manufacturers. The strong dollar makes goods made in the USA more expensive for foreign buyers. It also makes imports cheaper than U.S. made goods for consumers here at home. If the Federal Reserve raises interest rates and, like 1984, the dollar soars, there is no doubt that the Federal Reserve be forced to reverse course and bring interest rates back down. What worries experts like Ms. Lagarde is that an interest rate hike, under present conditions, might do more economic damage than could be repaired by reversing course and cutting interest rates by 0.25%. China's slowing economy and turbulent stock market are at the top of the list when it comes to reasons to be afraid of a U.S. interest rate hike.

In 1984 China was not a player on world markets. It was a very poor country still closed to the rest of the world. Today China is a major player on world markets. For years China had to buy dollars and sell yuan to keep its currency from appreciating too much and damaging China's exports. Under those circumstances American politicians had some basis for complaining and accusing China of currency manipulation. Of course the politicians never bothered to point out that in the process, China became the United States' biggest creditor. The flip side of China's currency manipulation was massive

Chinese buying of U.S. treasury securities that helped finance U.S. government spending. At $1.3 trillion, China owns the largest amount of U.S. treasury securities of any single holder. Pundits have long wondered what would happen if the day ever came when China stopped buying treasuries and started selling. Wonder no more. A slowing economy and wild stock market have drained available liquidity in Beijing.

China has so far spent $236 billion in a heavy handed attempt at calming the Chinese stock market. In addition to a wild stock market, Beijing is faced with unprecedented capital outflows. Retail investors worry about a further stock market decline. Business investors worry about the slowing economy. The capital outflows are enormous. They are so large that the downward pressure on the Chinese currency - the yuan - is forcing Beijing to intervene. Contrary to popular U.S. media reports, the Chinese did not voluntarily depreciate the yuan. The currency was dragged down by the capital outflows. Beijing has been fighting to stop the yuan's fall by selling dollars and buying yuan. In August, China's foreign reserves fell by a record amount - nearly $100 billion. While we don't have all the data yet, it is highly likely that China sold U.S. treasury securities to raise dollars to use in supporting the yuan. This does not mean the China pessimists are going to be right. At $3.56 trillion, China still has the world's largest cache of foreign reserves. What it *does* mean is that stock and currency market turbulence in China has far reaching consequences on global markets, including the market for U.S. treasury securities.

Even a modest 0.25% interest rate hike in the United States could, under present circumstances, make the outflow from China's currency gain momentum because

returns on the dollar would look that much more attractive. China is not alone. Other emerging economies are deeply concerned that they too might suffer capital outflows. They remember the economic pain from the 1997 currency crisis when capital fled emerging markets. Conditions in China alone make Ms. Lagarde's advice sound. World currency markets are unstable. Even a modest rate hike could have unwanted consequences. Why risk unsettling markets further? There is no urgency. Inflation is running far below the Federal Reserve's target of 2% a year.

But….the "normalizers" might prevail. U.S. interest rates might go up this week. And if they do, we should be prepared for the possibility that world currency, bond and stock markets might remain volatile for weeks and even months.

Fortunately, the U.S. economy is still slowly recovering from the 2008 recession. Europe is also still growing. And Beijing is doing far more than supporting its currency. Real reforms of State Owned Enterprises have been proposed by political leaders in Beijing. China wants to reduce export dependence and encourage domestic consumption. While there may be outflows and turbulence in emerging economics, this is not 1997. After that crisis, emerging economies adopted needed bank and market reforms. The massive inflows that preceded the 1997 crisis have not been repeated. The U.S. Federal Reserve might make a mistake and be forced to reverse course, but odds still are that the slow recovery from the great recession will survive.

I will have the next market review and update for you one week from today on Wednesday September 23, 2015.

All the best,

John Dessauer

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